No. 87-453

IN THE
Supreme Court of the United States
OCTOBER TERM, 1987

AMERADA HESS CORPORATION, *et al.*,
Appellants,
v.
DIRECTOR, DIVISION OF TAXATION,
Appellee.

On Appeal from the Supreme Court of New Jersey

BRIEF IN OPPOSITION TO MOTION TO DISMISS OR AFFIRM

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The state asserts a sweeping power to tax multistate businesses far beyond what this Court's decisions have sanctioned. Under its theory, a jurisdiction may freely disallow income tax deductions for costs associated with any form of economic activity that is conducted exclusively outside its borders.

The state brushes aside the territoriality and antidiscrimination principles that ordinarily constrain state taxing power. Territorial limitations, it says, have no bearing on income tax deductions: so long as the state adds nothing to the taxpayer's unitary gross receipts, the manner in which it allows or disallows deductions in

defining net income is constitutionally irrelevant, no matter how geographically tailored the deductions may be. Motion 14-15. Likewise, according to the state, constitutional protections against discriminatory state taxation do not apply in a case like this one: a state is free to impose unique tax burdens on an exclusively out-of-state business activity so long as there is no identical in-state activity that can be said to be favored. Motion 20-21.

The state's position threatens to undermine much of this Court's Due Process and Commerce Clause jurisprudence and fully justifies the concerns expressed by both groups of amici curiae. If, as New Jersey argues, a state may lawfully shape its allowable tax deductions to disfavor the exclusively out-of-state activities of a unitary business, even the most rigorous enforcement of this Court's limitations on the proper scope of a unitary business, coupled with the strictest insistence upon use of a geographically benign apportionment formula, will be powerless to deter the state from effectively taxing more than its fair share of multistate net income. And if a state may lawfully affix discriminatory tax burdens to any out-of-state activity that has no identical in-state counterpart, the free trade purpose of the Commerce Clause may easily be frustrated by the successive imposition of retaliatory tax measures that unduly penalize taxpayers on account of their exclusively out-of-state operations.

The state's position is at war with fundamental limitations on state taxing power. Its Motion reinforces the need for plenary review in this case.

1. The state does not dispute the central premises of our argument. It concedes that the WPT is a "cost" "attributable to oil production" (Motion 14), that "there is no crude oil production in New Jersey" (Motion 21), and that appellants' WPT costs therefore "have a geographic source outside" New Jersey. Motion 14. It

acknowledges that the effect of denying a WPT deduction is to "augment appellants' entire net income." Motion 19.

In our view of the case, those concessions are fatal. No state should be free to "augment" the taxable net income of a multistate taxpayer by disallowing a deduction for a significant class of costs whose "geographic source" is exclusively and necessarily outside the taxing jurisdiction. Geographic tailoring of deductions artificially inflates extraterritorial values, skews the tax base, and results in taxation beyond the state's lawful reach.

New Jersey reads the law quite differently. It acknowledges that its taxing power is subject to the "territorial constraints of the Due Process Clause" (Motion 2), and it apparently recognizes that its "net income base" must be free of "geographic bias." Motion 14. But its concept of geographic bias is eccentric. Under its theory, so long as the starting point for calculating taxable net income does not exceed the total gross receipts of a unitary enterprise, its treatment of deductions, no matter what their geographic source may be, "introduces no unconstitutional distortion to the net income base." Motion 15. But the net income base is determined by subtracting allowable deductions from gross receipts. If the deductions are geographically unbalanced, the resulting base will be geographically distorted even if the starting point of gross receipts has been determined on a permissibly neutral basis.[1]

The source of the state's apparent confusion is its reading of *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). The Court there held that a state may include in the preapportionment tax base of an integrated oil company "income derived from the extraction of oil and gas located outside the State and used

[1] As in the Jurisdictional Statement, we use "deduction" to signify any cost subtractable from either gross receipts or gross income in determining net income. *See* J.S. 7 n.7.

by the [taxpayer's] refining department." *Id.* at 210. New Jersey infers from that holding that it may both include the income from out-of-state oil production and simultaneously disregard the associated costs: "New Jersey's denial of a deduction for a cost [of oil production] which happens to have a geographic source outside the States [*sic*] does not distort the base to any greater degree than does inclusion of [oil production] income from a non New Jersey source." Motion 14.

That view of the case would convert *Exxon* into a tax collector's bonanza, allowing each jurisdiction to tax out-of-state income unencumbered by out-of-state costs. But nothing in this Court's opinion suggests that a state may properly separate production income from associated production costs, pulling the income into the state while leaving the costs behind. On the contrary, the Court plainly assumed that unitary "costs and charges" were inseparable from unitary income. 447 U.S. at 221.

The state's approach, moreover, cannot be squared with this Court's "internal consistency" test. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983). If every jurisdiction, following New Jersey's example, were to disallow a deduction for out-of-state oil production costs, an integrated oil company conducting a nationwide business would be taxed on far more than 100 percent of its unitary net income. Each state, whether producing or non-producing, would claim its apportioned share of production income, but production costs would be orphaned, allowed as an apportioned offset to income only by the state in which they were incurred.

New Jersey apparently believes that the courts are powerless to remedy the geographic distortions inherent in its tax scheme unless appellants demonstrate that "denial of a deduction for the WPT results in an irrational *amount* of their income being subjected to tax." Motion 14 (emphasis in original). The record here amply

satisfies that standard. New Jersey, through the operation of its add-back provision, dramatically increased the amount of appellants' taxable income and state tax liability. J.S. App. 84a.[2]

More fundamentally, however, the flaw in New Jersey's scheme is qualitative, not merely quantitative. When a taxpayer complains about a particular application of an otherwise structurally sound state apportionment mechanism, it may properly be held to a high standard of proof concerning the degree of distortion. *See Container*, 463 U.S. at 170. But where, as here, a state's mechanism is structurally defective, so that it necessarily distorts the net income base of every integrated oil company, the standard is different. Just as the Court "need not know how unequal [a tax] is before concluding that it unconstitutionally discriminates," *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981), it need not know how unfair New Jersey's geographically tailored deduction is before concluding that the state's approach is "inherently arbitrary." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920).

It is no more "unworkable" (Motion 15) to insist on geographically neutral income tax deductions than to require geographically fair net income apportionment formulas. In each case, the states enjoy a generous "margin of error" when they apply intrinsically even-handed principles to individual taxpayers. *Container*, 463 U.S. at 184. But states should have no greater freedom in their treatment of deductions than in their framing of apportionment formulas to adopt intrinsically unfair schemes that inevitably exaggerate the share of multistate income reasonably attributable to the taxing jurisdiction.

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[2] We are mystified by the state's repeated attack on our use of the phrase "add-back provision." Motion 8, 18. The source of the phrase is the opinion of the New Jersey Supreme Court. J.S. App. 2a.

Under these principles, a state may properly disallow a deduction for costs that are as likely to be incurred inside as outside the state. Interest payments to 10 percent shareholders—an example to which the state refers (Motion 15)—may well fall in that category, for there is no apparent reason to expect that all such payments have a geographic source outside New Jersey. That a particular taxpayer's interest payments in a given year may in fact have an out-of-state source would neither negate the structural fairness of the disallowance nor necessarily invalidate its application to that taxpayer.

What a state cannot do, however, is disallow a deduction for a substantial class of costs that are incurred exclusively or overwhelmingly outside the state's borders. New Jersey's treatment of WPT costs falls clearly in that category. It requires no individualized scrutiny of each taxpayer's circumstances to determine that the disallowance of such inherently out-of-state costs impermissibly distorts the net income tax base.

2. The state argues that the Commerce Clause provides no protection against New Jersey's discriminatory imposition of a unique tax burden on out-of-state oil production activities. Its theory is simple. The Commerce Clause, it says, has no application unless an in-state business activity is favored over an identical out-of-state activity. Motion 20. The add-back provision "does not favor in-state economic activity because, since there is no crude oil production in New Jersey . . . , there is no in-state ac[t]ivity to be favored." Motion 21.

New Jersey's argument trivializes the Commerce Clause, transforming it, in the words of amici Committee on State Taxation *et al.*, into a mere "equal rights act as between local and interstate industries." Br. 14. But the Commerce Clause has the more profound purpose of preserving "a free trade area among States." *American Trucking Ass'ns, Inc. v. Scheiner*, 107 S. Ct. 2829, 2839 (1987). The imposition of special tax burdens on an

out-of-state business activity "implicates central Commerce Clause values" (*id.*) regardless of whether the identical activity is carried on within the state. Like the unapportioned flat tax in *American Trucking Ass'ns*, New Jersey's add-back provision fails "the internal consistency test" and has the "inevitable effect" of inhibiting free trade. *Id.* at 2840. If each state were to attach special tax burdens to exclusively out-of-state business activities, multistate companies that engage in those activities would necessarily bear higher tax costs than intrastate companies with whom they compete. Imposing such economic handicaps on interstate companies solely because of their out-of-state business is incompatible with the free trade purposes of the Commerce Clause.

The state sees in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981), authorization to "singl[e] out for special tax treatment particular industries carrying on business within it." Motion 22. But the state has the case backwards. The Court upheld Montana's coal severance tax precisely because the severance occurred only in Montana. Nothing in the decision supports New Jersey's perverse claim that it can impose special tax burdens on oil production activities that occur only outside the state.[3]

3. The state's effort to belittle the importance of this case rings hollow. One cannot credibly argue that the geographical tailoring of income tax deductions is immune from constitutional scrutiny, and that states may lawfully force out-of-state business activities to bear unique tax burdens, but then suggest in the next breath that this case "does not have national ramifications." Motion 10. The power claimed by the state is extraordi-

[3] We explained in the Jurisdictional Statement (at 29) why *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117 (1978), on which the state also relies (Motion 21-22), gives New Jersey no license to single out for disfavored tax treatment economic activity that occurs only outside its borders.

nary. As the amici have shown, the principles at issue here have grave implications for a broad range of geographically localized business activities.

The state suggests that the case does not warrant this Court's full attention because New Jersey's "revenue gains [attributable to the add-back provision] are minute by comparison to total WPT paid to the federal government." Motion 10 n.7. And it implies inaccurately that WPT payments are a tiny fraction of appellants' total deductions. Motion 18. The fact remains, however, that the state stands to collect nearly $100 million in additional tax receipts as a result of the decision below (*see* J.S. 14) and that the state's interpretation of the add-back provision has increased appellants' tax liabilities by substantial, in some cases enormous, percentages.

The Court should note probable jurisdiction.

Respectfully submitted,

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OCTOBER 1987